Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

MAY 31 1996

In the Matter of	)	
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	)	
Allocation of Costs Associated with	)	
Local Exchange Carrier Provision of	)	CC Docket No. 96-112
Video Programming Services	)	

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COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY

ROBERT M. LYNCH
DURWARD D. DUPRE
JONATHAN W. ROYSTON

ONE BELL CENTER
ROOM 3520
St. Louis, Missouri 63101
(314) 235-2507

ATTORNEYS FOR
SOUTHWESTERN BELL TELEPHONE COMPANY

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SUMMARY[1]

Contrary to the tentative conclusions of the NPRM, the cost allocation principles of the Joint Cost Order are still more than sufficient to properly allocate plant costs and other common costs between regulated and nonregulated activities. The NPRM incorrectly assumes that it is no longer possible to allocate certain costs, such as loop plant costs, on a cost-causative basis. One alternative cost-causative method of allocating loop plant costs that LECs should be allowed to use is the relative number of service connections. Instead of mandating rigid, uniform cost allocation methods, as proposed in the NPRM, the Commission should continue to allow LECs the flexibility to determine their own cost pools and allocation methodologies consistent with the Joint Cost Order's hierarchy of cost allocation principles. Consistent with the deregulatory intent of the 1996 Act, the Commission should reduce Part 64 regulation and forbear from applying it to price cap LECs not subject to sharing.

The forward-looking network investment allocation principle is still as valid as when it was adopted in CC Docket No. 86-111 and it still adequately addresses the allocation of spare capacity. Except for allocation based on directly assigned investment, which might be appropriate for certain LECs, the NPRM's other proposed methods are unworkable or inconsistent with the Joint Cost Order or other regulatory principles. Specifically, the proposals to mandate a "cost capping" mechanism or a fixed allocator have a number of serious flaws. For example, aside from being the antithesis of cost causation, a fixed allocator would not drive costs in a manner consistent with individual markets, system architectures and regional variations in costs of material and labor

[1] Abbreviations used herein are referenced within the text.

resources. This "one-size-fits-all" approach would also be inconsistent with Congressional goals.

The imputation of pole attachment costs required by the 1996 Act should be determined in the same manner as the Part 64 fully distributed cost method, which is consistent with the fully allocated cost method in Section 224.

Introduction of new nonregulated services does not require exogenous cost reductions to price cap indexes. Likewise, the Commission should not use any new, arbitrary Part 64 investment allocation mandates to trigger any price cap index reductions. A regulatory decision to reallocate common costs does not necessarily indicate a meaningful change in the economic costs of producing any particular service or group of services. In any event, Part 64 is not necessary to protect the ratepayers of a price cap LEC that is not subject to sharing.

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Southwestern Bell Telephone Company (SWBT) respectfully submits these comments in response to the Commission's May 10, 1996 Notice of Proposed Rulemaking (FCC No. 96-214) ("NPRM") in the above-referenced proceeding. In this NPRM, the Commission proposes to reexamine the rules governing local exchange carriers' ("LECs") allocation of common costs between regulated and nonregulated activities.

I. INTRODUCTION

The Commission begins this NPRM with a now familiar quotation from the legislative history of the Telecommunications Act of 1996 (the "Act"), which explains that its goal is "to provide for a pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition."[2] However, in the 25 pages that follow, the Commission proposes to abandon the flexible cost-causative principles adopted in a series of complex and comprehensive proceedings that culminated in the Joint Cost Order.[3] Contrary to the deregulatory intent of the 1996 Act -- evidenced in the video area by its termination of all video dialtone regulations -- the Commission

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[2]Conference Report 104-458 on S.652, 104th Congress, 2d Session, February 1, 1996, at 113 ("Conference Report").

[3]CC Docket No. 86-111, 2 FCC Rcd 1298(1987), recon., 2 FCC Rcd 6283 (1987) ("Joint Cost Recon Order"), further recon., 3 FCC Rcd 6701 (1988).

proposes to adopt an approach to cost allocation principles which is highly regulatory and much less flexible than those used since the adoption of the Joint Cost Order. Some of the NPRM's proposals also constitute inappropriate uses of Part 64 for purposes beyond the mere identification of regulated vs. nonregulated costs and in conflict with the functions of other regulatory mechanisms.

The Commission states that this proceeding is intended to implement the video programming provisions of the 1996 Act.[4] However, no provision of the 1996 Act requires the Commission to adopt any additional cost allocation rules for video programming or to otherwise fundamentally alter the existing Part 64 paradigm, especially on such a short time-frame.[5] Some of the proposals in this proceeding appear to be based on the views expressed by some commenters in the Open Video Systems NPRM.[6] These commentors believe that Open Video Systems (OVS) and other video programming should be regulated with the same high intensity as video dialtone ("VDT").[7] Even the proposed restrictions in this NPRM have their origin in VDT tariff and Section 214 proceedings.[8] Congress never intended that its termination of VDT regulation would clear the way for re-imposition of more burdensome regulation of OVS and other video services.

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[4]NPRM, ¶2.

[5]See Section 302 of the 1996 Act.

[6]Implementation of Section 302 of the Telecommunication Act of 1996: Open Video Systems, CS Docket No. 96-46, FCC 96-99, released March 11, 1996. See, e.g., Joint Comments of Cablevision Systems Corp. and the California Cable Television Association at 31; Comments of the National Cable Television Association, Inc. at 23; Comments of Tele-Communications, Inc. at 6 ("[T]he Commission should immediately commence a proceeding to identify an appropriate allocator.") filed on April 1, 1996 in Open Video Systems NPRM.

[7]See, e.g., Reply Comments of American Cable Entertainment et al., at 17-19; Reply Comments of Adelphia Communications Corp. at 9, Reply Comments of Cox Communications, Inc. at 10; MCI Reply Comments, filed on April 11, 1996 in Open Video Systems NPRM.

[8]See, e.g., NPRM, ¶39

Also coinciding with these OVS commentors' pro-regulatory rally, the Commission has suddenly changed its position concerning the effectiveness of its time-proven cost allocation rules and decided that the cost allocation rules it has used for several years are not capable of performing the very task for which they were originally designed. The Commission states that:

> [t]he basic problem addressed in this proceeding is how to allocate common costs between the nonregulated offerings that will be introduced by . . local exchange carriers and the regulated services they already offer. Our current cost allocation rules were not designed for this task.[9]

On the contrary, that is exactly the task for which the cost allocation rules were designed. The Commission states that it is addressing this allocation problem "for the first time,"[10] but it fails to recall that this was exactly the same problem it addressed in an earlier comprehensive proceeding.[11] In CC Docket No. 86-111, the Commission adopted a flexible hierarchy of cost allocation principles to guide LECs in designing their individual cost allocation manuals ("CAMs") to allocate costs between the regulated and nonregulated activities they provided from time to time.[12] In contrast, the NPRM now proposes to hurriedly mandate rigidly uniform allocation factors for several of the major network investment and expense accounts. The Commission tentatively concludes that a fixed percentage factor should be used for most of these accounts, in complete disregard of cost-causation principles. This is indeed a sudden, unprecedented shift in the Commission's view of the effectiveness of its cost allocation rules and

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[9]NPRM, ¶2.

[10]NPRM, ¶18.

[11]In fact, the FCC devoted 65 paragraphs of the Joint Cost Recon Order to network cost allocation issues discussed in this NPRM.

[12]See Joint Cost Order,¶¶ 161-173, 222-240

inapposite to the Commission's frequent statements that its cost allocation rules are effective and eliminate any risk that LECs might cross-subsidize nonregulated services.[13] As recently as April 1996, the Commission relied on the effectiveness of its cost allocation rules to grant a waiver to permit US West to engage in a nonregulated activity involving resale of cellular service as a temporary substitute for landline telephone service.[14] Similarly, in VDT proceedings, the Commission held that existing safeguards, including Part 64 were effective in preventing cross-subsidy of nonregulated activities.[15]

To be consistent with the de-regulatory intent of the 1996 Act, the Commission should reduce, rather than augment, any Part 64 regulation. Part 64 has such limited application for a price cap LEC, especially if it is not subject to sharing, that the Commission should forebear from applying Part 64 to such LECs. The intent of the 1996 Act requires, at a minimum, that the Commission retain the flexible procedures that permit each LEC to design its own cost pools and cost allocation methodologies based on the hierarchy of cost allocation principles.[16]

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[13]Telephone Company-Cable Television Cross-Ownership Rules, Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking, 10 FCC Rcd 244, ¶¶161, 166, 179-182 (1994); Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier I LEC Safeguards, 6 FCC Rcd 7571, 7577 (1991)("[W]e determine that our existing cost accounting safeguards and those proposed in the Notice constitute a realistic and reliable alternative to structural separation to protect against cross-subsidy....").

[14]In the Matter of Request of US WEST Communications, Inc. For a Limited Waiver of Section 22.903 of the Commission's Rules, DA 96-605, Order released April 17, 1996, at ¶24. See also Order, GN Docket No. 90-314, 1996 FCC LEXIS 987, released Feb. 27, 1996 (PacTel PCS nonstructural safeguards).

[15]Pacific Bell Section 214 Order and Authorization, 1995 FCC LEXIS 5416, File No. W-P-C-6913 released Aug. 15, 1995, ¶115.

[16]Joint Cost Recon Order, ¶ 192. Cf. Second Report and Order, 11 FCC Rcd 2220 ¶¶106-124 (released Jan. 26, 1996) (discussing rules for cable TV cost allocation to franchises and cost categories which "allow for operator flexibility in determining specific allocators and allocation

(continued...)

II. THE COMMISSION'S EXISTING CAM PROCESS IS MORE THAN SUFFICIENT TO PROPERLY ALLOCATE PLANT COSTS AND OTHER COMMON COSTS

The Commission believes it must change Part 64 to address alleged problems in allocating loop plant and other costs between regulated and nonregulated activities. The NPRM suggests that loop plant presents the most difficult problem, but it is unclear why it reflects a tentative belief that the existing Part 64 rules are not sufficient. The NPRM describes three primary goals and a number of secondary considerations in deciding cost allocation issues, including prevention of cross-subsidy, administrative simplicity, adaptability to evolving technologies, uniformity and consistency with economic principles of cost-causation.[17] The NPRM describes an alleged problem with loop plant as follows:

> Because loop plant is primarily traffic-insensitive, the usage-based allocation process prescribed by our Part 64 rules does not result in cost-causative allocations.[18]

The NPRM incorrectly assumes that it is not possible to allocate loop plant based on usage consistent with Part 64. There are several possible methods of measuring usage consistent with Part 64.[19] For example, loop plant can be allocated based on the relative number of regulated vs. nonregulated service connections, which is indeed an indirect measure of relative

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[16](...continued) schemes").

[17]NPRM, ¶24.

[18]NPRM, ¶19.

[19]While there is no significant difference in the number of loops required for basic telephone service to an individual customer, loop investment is sensitive to some degree to factors such as growth in number of customers, additional lines, data services, enhanced services and video services. Under these circumstances, a service ratio based on the degree of penetration of the regulated vs. nonregulated services should be considered a reasonable attribution method of cost allocation.

use of the integrated network. In fact, this measure of relative use, or variations of it, were proposed by some LECs for video service prior to the 1996 Act.[20]

The service connection (or virtual loop) allocator is simple, adaptable to evolving technologies, and consistent with economic principles. For example, with a nonregulated video service, the cost of a given physical loop facility (single pair of copper wires or a single strand of fiber) does not change regardless of the number of customers served or the bandwidth of those services. When the same facility is used to jointly provide one regulated service and one nonregulated service, the associated investment could be divided into two parts.[21] Under the service connection alternative, after the uniquely identifiable items of the integrated network are directly assigned to regulated/nonregulated, the remaining jointly used investment is split between regulated and nonregulated based on a forecast of the relative number of service connections provided to the end users of each type of service. This method of allocation of jointly used plant would be cost causative because it is based on the actual and projected use of loop plant as measured by the relative number of communication channels being provided over the facilities. It would be easy to administer, monitor and periodically update as other new services are introduced in the future.

Presumably, the proper purpose of cost allocation rules is to prevent cross-subsidy, not

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[20] See, e.g., BellSouth Corporation's Cost Allocation Manual Revisions, filed June 30, 1995 (using an allocator based on "projected cable service and telephony subscriber circuit counts"); Southern New England Telephone Company's Section 214 Application for Permission to Construct Telecommunications Facilities, filed Jan. 25, 1996 at 13 and Attachment No. 3 (explaining that a 50% allocator reflects the "maximum projected relative use of cable connections" consistent with Section 64.901(b)(4)'s forward-looking allocator based on relative regulated/nonregulated usage).

[21] The investment can be subdivided further as more regulated and nonregulated service connections are added.

to to provide incentives to engage in sub-optimal or inefficient market behavior.[22] However, by definition, cost allocation rules are only required in a regulatory framework in which the link between cost allocation and prices has not been severed. SWBT rejects the suggestion that it is necessary to prescribe video-specific cost allocation rules in order to accomplish the purpose of cost allocation: prevention of cross-subsidy of nonregulated activities. Instead, the general guidelines already contained in the cost allocation rules are more than sufficient to accomplish this purpose. Under the existing Part 64 rules, a LEC is able to customize the cost allocation principles to its own operations. Also there must be flexibility in determining how to measure usage of network investment. This flexibility is necessary to accommodate a variety of architectures, operating environments, service offerings and record detail inherent in evolving technologies. As new services are offered, the rules must remain sufficiently flexible and broad to continue to accommodate the different circumstances of different LECs.

III. THE COMMISSION SHOULD NOT PRESCRIBE SPECIFIC RULES FOR THE ALLOCATION OF THE COST OF VIDEO PROGRAMMING OR OTHER NONREGULATED SERVICES

A. Loop Plant

1. The Usage-Based Investment Allocator is Sufficient

Almost ten years ago, after extensive debate, the Commission adopted the current method for allocating central office and outside plant investment. Until this NPRM, the Commission had not expressed any doubts about this method. Generally, the current method (the "network

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[22] See, A. KAHN, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS, xxxii-xxxvii (MIT Press 2nd Printing 1989)(Introduction: "The Anomalies and Distortions of Partial Deregulation").

investment allocator") allocates loop plant used for video or other nonregulated services on the basis of highest projected nonregulated use during the next three years. While this method could be more flexible,[23] it is a reasonable method which has worked well. It uses a reasonable planning horizon and it permits the LEC to adopt its own cost-causative measures of relative use based on the technology used by the LEC. The Commission's Part 64 rules do not prescribe any specific measure of relative use. (An example in CC Docket No. 86-111 referred to the number of "units" of nonregulated use compared to the total "units" of use.) This network investment allocator has allowed LECs to adopt a number of measures of relative use. In fact, in part VI of SWBT's CAM, SWBT lists three methods of measuring relative use of network equipment for purposes of this type of forecasting allocator. In adopting its network investment allocator, the Commission explained the rationale supporting it as follows:

> The accurate allocation of costs on a cost causational basis depends upon the correct identification of the activity that is supported by the cost. Costs are incurred in anticipation of future demand and depending upon the cost category, allocators based on even the most recently available pattern of relative use may result in large retrospective accounting adjustments when the costs are trued up to actual costs because of shifts in relative demand. The problem is most pronounced for investment costs since only a small portion of the investment will be recovered by the revenue from current use. To take an extreme example, the cable vaults under city streets are built for the highest demand imaginable over their operating lives because their capacity is quite literally set in concrete. Central office switching equipment can be expanded in capacity on shorter notice, but the decision to incur the cost of equipping a switch with an additional circuit is not based simply on the immediate demand for service. It is based on a forecast that the circuit's cost can be recovered over its expected service life. ...

[23]For example, this allocation method would more closely reflect cost-causation if reallocation of investment from nonregulated to regulated were allowed more easily when external factors reduce the nonregulated usage of investment.

> For network plant investment (i.e., central office equipment and outside plant) capacity is based upon the anticipated, not the current demand level. We believe the lag between investment and demand can be taken into account by basing the allocation factor on forecasted and not actual relative regulated and nonregulated use.[24]

This justification is as true today as it was a decade ago There is no reason why forecasted use cannot continue to allocate network investment costs between the regulated and nonregulated activities.

The Commission provides several flawed reasons for its departure from a usage-based allocation method. First, it claims that loop plant should not be allocated based on relative use because loop plant costs are allegedly not traffic sensitive While the loop facility itself may not be traffic sensitive, the utilization of the facility for multiple services is usage sensitive. Relative use can and should be used as a reasonable allocation method. Second, the NPRM tentatively concluded that allocation between video and telephony based on usage characteristics of the two services may result in an unfairly large allocation to video [25] While certain traditional measurements of relative use (e.g., MOU) could result in seemingly excessive allocations of costs to video, other usage-based methods, such as those based on a count of subscriber connections or virtual loops, yield reasonable results Third, the NPRM suggests that the existing cost allocation rules did not anticipate that loop plant would be used to a significant extent for nonregulated activities.[26] On the contrary the Joint Cost Order did not indicate that its

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[24]Joint Cost Order, ¶¶ 167-168 (emphasis added).

[25]See NPRM, ¶¶ 30, 33, 34. The Commission recognizes that an over-allocation of common costs to video would discourage LEC entry into the video market. Id., ¶20.

[26]NPRM, ¶51

cost allocation principles would be valid only so long as most of a LEC's activities were regulated. In fact, the whole premise of the Joint Cost Order was that LECs would increasingly provide nonregulated services. One example in the Joint Cost Order contemplated a LEC using one-third of its switches as a "major source of nonregulated activities."[27]

2. Most of the Commission's Other Proposed Methods of Allocating Loop Plant Are Inadequate or Unreasonable

The Commission reviews five potential methods of allocating loop plant for the apparent purpose of selecting one uniform method for all LECs. Aside from opposing prescription of an inflexible, uniform method, SWBT also has specific objections to some of the alternatives considered in the NPRM. If the Commission decides it must change the cost allocation method for loop plant, SWBT recommends that the Commission allow each LEC to propose its own cost-causative allocation method. This CAM process need not delay introduction of a service such as OVS since any Commission approval could be predicated upon the LEC's filing of appropriate CAM changes.

a. Direct Assignment Alone Would Not Be An Adequate Allocation Method.

Because of the numerous common costs in integrated video architectures, direct assignment could not be used as the sole method of allocation. Consistent with Part 64, no matter which allocation method a LEC selects for common costs, it should first use direct assignment to the maximum extent possible.

b. LECs Should Be Given the Option of Allocating Loop Plant Based on the Ratio of Directly Assigned Investment

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[27]Joint Cost Order, ¶166.

If the Commission makes any changes to the existing Part 64 rules for allocating investment such as loop plant, it should allow, among other alternatives, indirect attribution based upon the ratio of directly assigned investment. This method could be appropriate for a network with sufficient directly assigned investment and would be consistent with other flexible methods allowed by the Part 64 hierarchy of cost allocation principles. If a LEC selected this method, it should be allowed to design its cost pools in the manner best suited to its system architecture. In other words, the LEC should be allowed to establish two or more direct cost pools and it should be allowed to decide which direct cost pools have a cost-causative linkage to the common cost pool or pools. For example, a LEC operating video systems with more than one architecture might use one pool for one type of system and a different pool for systems that have a substantially different architecture.

c. A Cost Allocation Ceiling Would be Unworkable

There are several problems with a cost allocation ceiling including those described below. First, a cost allocation ceiling based on the "stand-alone" costs of telephone services would represent an unwarranted and vast departure from the cost-causative principles of the Joint Cost Order. After a period of time, the "stand-alone" costs used to establish the ceiling would not reflect the changes in costs caused by regulated activities. As a result, costs allowed might have little, if any, relationship to the actual costs caused by regulated activities. Second, one would not be able to establish that the current costs are indeed the stand-alone costs in all cases given the existence of distorting regulation, which over-allocates costs to nonregulated activities. Third, this method would be administratively costly and difficult for both the Commission and the LECs because it would have to be implemented on an exchange-by-exchange basis as video is deployed. LECs do not maintain disaggregated records that specifically identify expenses and certain types of plant on an exchange-by-exchange basis from which all of the relevant stand-alone costs could be determined easily. Fourth, a ceiling assumes that the loop plant or other capped plant category will not be upgraded or replaced to furnish improved and new regulated services or for purposes of growth in regulated service or service areas. As a result, they would be a disincentive to growth, competition and infrastructure deployment. A regulatory framework that attempted to correct for all of these problems would be at least as complex as price cap regulation, and it would only govern Part 64 regulation of certain categories of costs. Thus, it would unnecessarily complicate the Part 64 process.

d. "Cost Capping" Would Be Incompatible with Other Regulatory Proceedings

Adoption of the NPRM's proposed cost allocation ceiling would be an inappropriate use of Part 64. This proposal would establish an absolute ceiling on costs, although Part 64 is only intended to identify what fractions of total costs are regulated vs. nonregulated. Unlike other regulatory mechanisms, such as price caps or universal service support, Part 64 is not intended to serve any pricing purpose or as a method of further analysis or categorization of the regulated costs identified through the CAM process. This proposal would attempt to use Part 64 as an arbitrary "prudency" review of costs incurred in the regulated portion of a LEC's operations -- an emphasis previously foreign to Part 64 -- and would implement an unwise system of "cost capping." In the universal service proceeding the Joint Board has been given responsibility to adopt rules governing the recovery of loop costs. In the LEC price cap review proceeding, the Commission is considering reforms such as elimination of earnings sharing and revision of the indexes governing the rates that provide interstate loop cost recovery. Adoption of the NPRM's cost capping proposal would attempt to use Part 64 for purposes already being served by these and other regulatory mechanisms and would conflict with the consideration of loop cost recovery in the universal service proceeding.

e. A Fixed Factor Would Be Completely Arbitrary and Incompatible with the Joint Cost Order.

The only silver lining SWBT sees in a fixed factor is its relative simplicity.[28] It would be relatively easy to administer, but few will be satisfied with the results. If a sufficiently high percentage allocation to video were adopted, those whose system architectures are less video intensive than the average system would have costs over-allocated to video; as a result, LECs would be at a competitive disadvantage and video consumers would be denied lower prices. More than any other mandatory allocator, the chosen factor would provide an incentive for lack of diversity, quality and robustness. Forced to allocate the same exact proportion of costs, the LEC's video business plans would be driven toward that "budget." Perhaps only a single architecture would fit that "budget." And, the losers would be the consumers whose competitive choices would be limited and the LECs, whose ability to compete through product diversification would be narrowed by regulation. In addition, the LECs would be at a disadvantage compared to the incumbent cable operators, who would not be subject to the disincentives created by such mandatory cost allocation methods -- apparently, even if those cable operators begin to provide

[28]A fixed factor approach is likely not as simple nor as easily administered as it first appears. The Commission presumes a fixed factor approach will avoid forecasts. (NPRM, ¶39). However, the factor chosen must reflect at least an implicit forecast. To the extent a fixed factor is adopted which is far below what is required by the proportion of LEC customers subscribing to video services, a true-up of the factor would be required for consistency with cost-causative principles. Alternatively, if the initial factor is well above the share of LEC resources devoted to video services, LECs will likely petition for review and adjustment of the fixed factor.

telephone services, given that the Commission erroneously assumes that a new telephone company is not subject to any of the Commission's traditional LEC regulations.[29] Further, if the Commission required an inflated fixed factor and used that factor in determining prices, it could result in a video product price which is too high compared to the market, making it impossible for the service to compete. The Commission has only resorted to fixed factors in extreme circumstances, and the results have been shown to severely distort the marketplace.[30] Besides, the Commission should not engage in this sort of manipulation of the video marketplace under the guise of protection of regulated service ratepayers

A fixed factor defies even common sense. Despite the technically diverse broadband system architectures that may support a variety of regulated and nonregulated services and regional variations in costs of raw materials and labor, the Commission's proposal would require the same percentage allocation of costs between regulated and nonregulated in all cases. For example, if the Commission adopted a 50% allocation, the same 50% would be allocated in an integrated system that included only basic cable service as in a system that included basic cable, video-on-demand, interactive video and other new nonregulated services. The arbitrariness of this approach to cost allocation is self-evident: Fixed factors have not been used in Part 64 because they do not reflect cost-causation. In view of the availability of a variety of cost-causative allocation methods, including usage-based allocators, a fixed factor should be out of the question. As discussed above, the usage-based service connection method is but one of several reasonable measures of cost-causation.

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[29]NPRM, n.4.

[30]KAHN, ECONOMICS OF REGULATION at I: 153-54 & n. 73.

The NPRM appears to agree that a fixed factor is a last ditch effort to find a solution to the inherently arbitrary process of allocating common costs. It states:

> A fixed factor approach for non-traffic sensitive loop plant presumes that a cost-causative allocation is not possible. When a cost-causative method is not available, the allocation must be based on other considerations such as demand or public policy considerations.[31]

SWBT has already shown that a cost-causative allocation based on a relative number of service connections is possible and yields reasonable results. Other methods are also possible based on use, although some would yield unreasonable results. Therefore, since usage-based and other cost-causative methods are available, it follows that a fixed factor should not be used. Even assuming *arguendo* that a cost-causative basis of allocation is not possible, demand can in fact be considered in determining whether the allocation method used for each system is reasonable. Based on demand for video service, an allocation should be used that would obtain a reasonable contribution to joint and common costs from video services. An allocation that keeps video prices too high will lower video's contribution, causing the allocation to be unfair.

While a fixed factor would be relatively simple and easy to administer, the need for frequent revision would thwart the goal of administrative simplicity and, for the sake of simplicity, it frustrates the other goals identified by the Commission. Unless a fixed factor is established on the basis of some economic principles and reviewed continually, it would not adapt to the rapidly changing technology and communications environment. Also, one of Congress' purposes in enacting Section 653 of the 1996 Act was to allow LECs "to tailor

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[31] NPRM, ¶41.

services to meet the unique competitive and consumer needs of individual markets."[32] Unless different fixed factors were adopted for different markets, and otherwise guided by economic principles, a fixed factor would be contrary to the Congressional desire for individual market-based design. A uniform fixed factor across all markets, established without regard to cost-causation, would not drive costs in a manner consistent with individual markets, system architectures and regional variations in costs of material and labor resources. Such a standardized approach to cost allocation also would frustrate the Congressional goal "to encourage investment in new technologies and to maximize consumer choices of services."[33]

In adopting CAM uniformity in 1993, the Common Carrier Bureau (Bureau) only required uniformity in "selected areas in which the LECs' operations are very similar" and in which they did not have "differing operational characteristics."[34] The architectures of various video systems proposed by the LECs have been extremely diverse, as reflected in the details of system design included in the LECs' Section 214 video programming applications. The LECs' video operations have many dissimilarities and the operational characteristics of their video networks are significantly different from one another In addition, under the 1996 Act, LECs have four different regulatory options for entering the video programming market, which will lead to further diversity -- especially if the same LEC combines two or more of these options. Thus, uniformity in this area also would be inconsistent with the rationale of the Bureau's CAM uniformity decisions.

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[32]Conference Report at 177; NPRM, ¶4 (emphasis added).

[33]Conference Report at 172.

[34]Implementation of Further Cost Allocation Uniformity, 8 FCC Rcd 4664 ¶6 (1993).

B. Switching Plant

Here also, the NPRM suggests to impose a single fixed percentage allocator to replace the cost-causative network investment allocator Changes in switch technology are not making it impossible to measure cost-causation. Instead, these changes require that flexible alternative methods be allowed. The NPRM suggests mandating technology-specific methods rather than allowing the Part 64 process to work. Even with the proliferation of packet switching, cost-causation analysis based on usage measurement is possible The duration of a call may not be an appropriate usage measurement for all switch technologies, but LECs should be allowed to propose other methods in their CAMs.[35] ATM equipment[36] and other new technologies might add a further level of complexity to the traditional MOU measurement procedures for switching investment allocation, but a cost-causative allocator can also be developed for this equipment. One option, among others that LECs should be allowed to use, is a ratio based on the number of ports on the ATM switch used for regulated vs. nonregulated services.

Particularly confusing is the NPRM's statement that "economic principles of cost causation would appear to support a fixed allocator for switching costs."[37] A fixed allocator has nothing to do with cost causation and has even less of a basis in any reliable economic principle of which SWBT is aware.

C. Network-Related and Maintenance Expenses

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[35]NPRM, ¶44.

[36]As SWBT has explained in other pending proceedings (Application for Review of RAO 25), not all ATM equipment is used for switching purposes.

[37] Id.

Rather than suggesting any change to Part 64 concerning network-related expenses, the NPRM appears to be proposing to continue to allow LECs' CAMs to allocate these expenses based on the allocation of the underlying network facilities Of course, to the extent the Commission is implying that a fixed factor or other prescribed method should be used uniformly by all LECs for allocating network-related expenses, SWBT objects for the same reasons set forth above.

The Commission should continue to allow LECs to allocate maintenance costs based on actual usage and should allow other reasonable cost-causative methods. In the Joint Cost Order, the Commission concluded that unlike plant investment, "maintenance expense ... will not be allocated on peak relative use because we believe that maintenance expense more closely tracks the current usage than the long-term forecasted usage."[38] There is no reason for the Commission to reach a different conclusion now. If any changes are made, more, rather than less, flexibility should be allowed.

D. Marketing Expenses

The Commission should retain the marketing allocator adopted in the Joint Cost Order. However, since use of the marketing allocator is supposed to be minimized,[39] the Commission should also allow increased flexibility to use attribution measures other than the marketing allocator for certain marketing costs, as determined by the LEC consistent with cost-causation. With the increased variety of products and services offered by LECs and their affiliates, increased variety in joint advertising and marketing arrangements should be expected. Thus,

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[38]Joint Cost Order, ¶ 173.

[39]Id., ¶162.

LECs should be allowed to propose in their CAMs a variety of methods of indirectly attributing the joint marketing and advertising costs incurred in selling or promoting the image of various combinations of their new and old products and services. Instead of requiring the use of the marketing allocator for certain advertising costs, the Commission should allow LECs to use indirect attribution methods to allocate institutional advertising costs based on cost-causative linkages to other related cost pools or accounts or to the costs incurred by affiliates.[40] This flexibility will avoid creating disincentives to joint advertising of the various regulated and nonregulated products and services.

E. General Allocator (Overheads)

The general allocator should be clarified as set forth in the proposed rule attached as Exhibit "A". As currently defined and due to conflicting references to "total company expense" in the Joint Cost Order and other more recent proceedings, it has become unclear whether certain costs are to be included in the calculation of the general allocator ratio, such as nonoperating costs, costs presumptively excluded from regulation. costs of goods sold, lobbying costs, losses on sale of plant, and other costs that are not attributable to regulated or nonregulated operations.[41]

IV. RULE CHANGES ARE NOT NECESSARY TO ADDRESS THE ALLOCATION OF SPARE CAPACITY

The Commission identifies several factors that lead it to believe that the current method of allocating spare capacity needs to be reexamined. These factors are: (I) the Commission's

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[40] For background on SWBT's position concerning the marketing allocator, see Response of SWBT, at 37-49, filed May 2, 1995, in Order to Show Cause, AAD 95-32, 10 FCC Rcd 4407 (1995).

[41] For background on SWBT's position concerning the general allocator, see id. at 50-67.

perception of an increasing relative magnitude of spare facilities; (ii) its belief that as a result of the 1996 Act, much of the spare capacity will be used exclusively for nonregulated activities; and (iii) its contention that the existing method was not intended for investment that is used to a significant degree for nonregulated activities. None of these factors supports a change in the network investment allocator adopted in 1987. First, as SWBT already explained, nothing in CC Docket No. 86-111 indicates that the network investment allocator would only apply so long as the nonregulated use of that investment is minimal. Second, the quantity of spare capacity has no bearing on the validity of the cost allocation method. The existence of spare capacity in sufficient quantity to require allocation is all that matters and that has not changed. Spare capacity was as much of a concern in 1987 as it is now. In 1987, the Commission had the same concern that "new nonregulated network services will experience higher growth rates than established regulated services,[42] and yet, the Commission balanced all of the relevant considerations and determined that a three-year forward-looking allocator would adequately address this potential for disparity in growth rate. The Commission understood that a method that attempts to forecast long-term use would be unreliable and arbitrary. Given the variety of new regulated services LECs are offering and the formation of nonregulated affiliates to offer some of the high growth nonregulated services under the 1996 Act, there is no basis to reexamine the assumptions underlying the network investment allocator.

Finally, unless the Commission intends to change the definition of nonregulated activities, it is pure speculation for the Commission to claim that most spare capacity will be

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[42] Joint Cost Recon Order, ¶37.

used "exclusively" for nonregulated activities.[43] The Commission offers no support for this hypothesis. On the other hand, if the Commission intends to deregulate (for federal accounting purposes) all activities other than the core services that incumbent LECs are required to continue providing, then the Commission's conclusion is plausible Even if it is true, the Commission has not yet made it a reality. And even if this speculative prophecy is fulfilled, the three-year forward-looking allocator provides sufficient protection. As soon as a LEC determines that its spare capacity will be used for a larger share of new or existing nonregulated activities during the next three years, it must reallocate investment. Nothing in CC Docket No. 86-111 indicated that the network investment allocator would not apply in the event a LEC began planning to use a substantial portion, or even a majority, of its network for nonregulated activities.

The Commission asks whether "today's rate payers [should] pay for network improvements incumbent [LECs] make in anticipation of future competition in their core markets." Since "core markets" by definition are regulated. the cost of upgrades to these regulated networks should be regulated. If the Commission deregulated the services which are subject to competition, it would not be necessary for regulators to worry about who pays because the LEC would invest at its own risk. In any event, in a price cap environment in which the link between costs and rates has been severed, today's ratepayers would not pay anything extra to receive the benefit of network upgrades.

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[43]The Commission has implied that it intends to expand the definition of nonregulated activities, but it has not sought comment on that issue here. But see In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, Notice of Proposed Rulemaking, FCC 96-182, released April 19, 1996, ¶120. Also, in the NPRM, the Commission appears to equate "nonregulated" with "competitive" even though there are many regulated services that are already competitive. See NPRM, ¶¶23-25, 29.